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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

Nos. ~~875-883~~ 11-19

IN THE MATTER OF

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,

Debtor.

GROUP OF INSTITUTIONAL INVESTORS, and MUTUAL SAVINGS BANK GROUP,

Petitioners,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,

Respondents.

No. 988

RECONSTRUCTION FINANCE CORPORATION,

Petitioner,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,

Respondents.

BRIEF OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY IN OPPOSITION TO PETITION OF GROUP OF INSTITUTIONAL INVESTORS AND OTHERS FOR WRITS OF CERTIORARI

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March 21, 1942.

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The obvious objective of the Petition filed by the Group of Institutional Investors and Mutual Savings Bank Group (No. 875-883) is to secure from this Court through the use of the *writ of certiorari* an annulment, in respect of cases arising under Section 77 of the Bankruptcy Act (11 U. S. C. A., Sec. 205), of its decision in *Consolidated Rock Products Company* v. *Du Bois* (312 U. S. 510), to the extent that

it holds that mortgage liens may not be displaced or equities either recognized or extinguished without specific Findings of value supported by adequate underlying data (pp. 520, 521, 526, 527).

This is equally true of the Petition filed by Reconstruction Finance Corporation (No. 988) and the Supporting Memorandum filed by the Interstate Commerce Commission, as *Amicus Curiae* (Nos. 875-883 and 988).

Chicago, Milwaukee, St. Paul and Pacific Railroad Company (herein called the Railroad Company) respectfully asks that these Petitions be denied for the following reasons:

First: Without specific Findings of value, supported by adequate underlying data, it is impossible for the District Court or the Circuit Court of Appeals to exercise the "informed, independent judgment" which is the *sine qua non* of the judicial determinations which the Court is required to make in performing its duty under subsection (e) of Section 77.

Second: Since subsection (e) of Section 77 expressly provides and undertakes to prescribe the rules for a valuation of the Debtor's property whenever necessary, any contention that *Consolidated Rock Products Company* v. *Du Bois* is inapplicable to cases under Section 77 because it arose under the former Section 77B of the Bankruptcy Act (48 Stat. 912) is quite untenable.

Third: The underlying data assembled in the Report of the Interstate Commerce Commission in this proceeding are not adequate to support the Findings necessary to sustain the Plan of Reorganization certified by the Interstate Commerce Commission to the District Court.

For the purposes of this Brief, designed merely to show the necessity for and the complete default in valuations and data to support valuations of the properties of the Railroad Company as a whole and by mortgage sections, it will be sufficient to refer to the treatment proposed for the Fifty Year 5% Bonds of 1975.

To do more would offend the rule that one must not carry coals to the town of New Castle.

These Bonds outstanding in the amount of $166,395,096 represent in a very large measure new money brought into the property of the Railroad Company in 1928, and are secured by an indenture known as the Fifty Year Mortgage to Guaranty Trust Company of New York and Merrel P. Calloway, as Trustees. The security under the indenture (and this is of very great significance in this discussion) consists of three major items (one a contested lien) as follows:

(1) A first lien upon so much of the transportation System of the Railroad Company (approximately 3,000 miles of railroad) as lies between the Missouri River and Puget Sound (Tr. 264-295, 2251).

(2) A first lien upon the leasehold estate of the Railroad Company in the railways and properties of the Terre Haute Southeastern Railway Company, giving it access to the coal fields of Indiana and Illinois (Tr. 293, 2171).

(3) A first lien (contested by the Trustee of the General Mortgage) upon 575 miles of railway (sometimes referred to as the "Seventeen Pieces of Track") in the area between the Missouri River and Lake Michigan (Tr. 2171).

Let us show very briefly what happened, and the data or evidence to support what happened, to these three major items of security under the Report of the Interstate Commerce Commission:—

First of all, the entire mileage between the Missouri River and Puget Sound—approximately 3,000 miles of railroad upon which the Fifty Year Mortgage is an unquestioned first lien—is taken away from the Fifty Year Mortgage without valuation or appraisal and is placed under the lien of a new First Mortgage securing an issue of new First Mortgage Bonds in the amount of $80,952,171, in which the holders of the Fifty Year 5% Bonds are given *no* participation whatever (Tr. 2226; 2269). There was no segregation study to determine the relative earning power of the lines west and the lines east of the Missouri River. There was no contributary traffic study to evaluate the traffic contributed by the western lines to the eastern lines. There was no severance study to determine the loss that would be sustained by the eastern lines if the western lines were detached and put into a competitive system. All that the Interstate Commerce Commission had as the basis for its allocation of $548,533,321 of new securities under the Plan and its apparent conclusion that the mileage west of the Missouri River being worthless could be taken away with impunity were studies from the files of the Railroad Company indicating that at certain levels of Railway Operating Revenue the western lines in the past had earned no income. One of these studies indicates that in 1930 when Railway Operating Revenues were $142,569,632, and the Income Available for Interest was $18,979,408, there was a deficit on the lines west of the Missouri River of $142,591—a factor which seems to have been given weight by the Interstate Commerce Commission (Tr. 2252). It is there-

fore quite interesting to note—(a) as utterly discrediting this data, and (b) as reflecting the fundamental economic changes that have occurred in the railway industry since this data was prepared that in 1941, when Railway Operating Revenues were only $139,646,122 (nearly $2,000,000 less than in 1930) the Income Available for Interest was not less than $28,939,719—approximately $10,000,000 more than was earned on the higher gross of 1930 and nearly twice the sum required to service the full 5% interest of the entire issue of Fifty Year Bonds.*

What the Interstate Commerce Commission used in lieu of valuations of the Railroad Company's properties by mortgage sections was a computation based upon a study in the files of the Railroad Company apportioning income for the year 1936 on the basis of estimates for four months of that year, multiplied by three to equate the figures to the full twelve months: a computation which was condemned as "incomplete and inaccurate" by a credited analyst (Tr. 2207, 2254). There was no evidence that the basic figures were accurate (they appear to have been compiled from data furnished various States for tax purposes) and no evidence to indicate that the four months were fairly representative or that sound conclusions could be drawn from such a restricted study. On the contrary, the evidence was that instead of an estimate for four months the figures should be actually ascertained for the years 1936 and 1937 (Tr. 1000). This four months data placed in the record in connection with an earlier Plan which left existing liens undisturbed was, nevertheless, taken and used by the Interstate Commerce Commission as the *sole* basis for the most drastic Plan ever devised for a Class I Rail Carrier for the

* See data at pages 18, 19, 20 of the annexed Cross Petition of the Railroad Company.

strangely whimsical reason "that if the earnings studies for 1936 are to be rejected there is no satisfactory substitute short of a new segregation study embracing the entire system" (Tr. 2254).

Passing now to the second item of security: the lien of the Fifty Year Mortgage upon the leasehold estate of the Railroad Company in the lines of the Terre Haute Southeastern Railway Company. There could not well be a valuation or Findings of value respecting this leasehold estate because the Interstate Commerce Commission proposes in its Plan that the Lease be repudiated in order to induce (they object to the word "coerce") the holders of Bonds of the Terre Haute Southeastern Railway Company to accept a change of status—a change itself violative of the fundamental doctrine of *Consolidated Rock Products Company* v. *Du Bois* for the reason that the proposal is to issue a new Bond bearing 2.75% fixed interest and 1.5% contingent interest par for par to various Bonds of the Terre Haute Southeastern Railway Company, or its predecessor in title, some of which bear 4% interest, some 5% interest, some of which bear fixed interest, some contingent interest, but all of which are accorded identical treatment under the Commission's Plan (Tr. 2212-2218; 2235-2237). It is interesting and significant that in connection with another phase of the reorganization proceeding, this leasehold was determined by the District Court "to have yielded a profit in excess of rental of $1,966,546 for 1936 and $1,820,687 for 1937 (Tr. 34). Incredible as it may seem the Interstate Commerce Commission proposes that the District Court, sitting in bankruptcy as a court of equity (a court whose favorite jurisdiction is the specific performance of contracts) shall renounce and repudiate a highly profitable Lease which is validly pledged as security for the

Fifty Year 5% Bonds in order to "coerce" (no other word is appropriate) acceptance by holders of Bonds of the Lessor, the Terre Haute Southeastern Railway Company, of an annual reduction of interest from $1,023,580 to $931,982—a net reduction of exactly $91,598 (Tr. 1317; 2212-2218). Let us here point out that the income derived from this leasehold, which is part of the security for the Fifty Year Bonds and which the Interstate Commerce Commission proposes to destroy unless the holders of the Lessor's Bonds accept the adjustment thus proposed, was sufficient in 1936 and 1937, according to the specific Findings of the District Court already mentioned, to provide for nearly two-fifths of the total interest requirements on the entire issue of Fifty Year 5% Bonds outstanding in the amount of $106,395,096 (Tr. 34).

Coming finally to the third item of security under the indenture securing the Fifty Year 5% Bonds:—its lien (contested by the Trustee of the General Mortgage) upon 575 miles of railway (sometimes referred to as the "Seventeen Pieces of Track") in the territory east of the Missouri River. The Interstate Commerce Commission did not undertake to determine whether these lines of railway representing more than twice the lineal mileage between the City of Washington and the City of New York, belong to the Fifty Year Mortgage or to the General Mortgage. Nor did it undertake to value this mileage or determine its earning power or value to the System. To anyone familiar with railway operations it would seem reasonably certain that these "Seventeen Pieces of Track" constitute strategic lines giving access to important areas of population or to vital traffic producing industries and that no Plan of Reorganization could be fair and equitable which failed to value this mileage from the standpoints (a) of its actual

earnings on the basis of mileage alone; (b) of the value of the traffic which it contributes to the System, and (c) of its potential injury to the main lines embraced in the Railroad Company's System if severed therefrom. It may, moreover, be noted in passing that a definite determination of the question left open by the Interstate Commerce Commission whether this railway mileage is subject to the prior lien of the General Mortgage or the Fifty Year Mortgage is an "obvious requirement" of *Consolidated Rock Products Company* v. *Du Bois*. To quote a brief but decisive line from this Court's opinion in that case "there must be a determination of what assets are subject to the payment of the respective claims" (p. 520).

The Circuit Court of Appeals, referring to the necessity of specific Findings of Value, says in its Opinion:

> "Our criticism is not directed to the fact that the findings were embodied in the Commission's report (a large part of which is devoted to a discussion and statement of the evidence) rather than stated specifically as findings. But the fault lies in the fact that we are left uncertain, or in the dark, as to the findings of the Commission. The evidence might support a finding of a larger or a smaller amount. Which should we accept?" (Tr. 2316)

The plight of the Circuit Court of Appeals is exemplified in a most convincing fashion by what is shown as to the earning capacity of the leasehold estate of the Railroad Company in the line of the Terre Haute Southeastern Railway Company which, as already shown, constitutes one of the three major items of first lien security for the Fifty Year 5% Bonds of 1975. These bonds are deprived of every vestige of a first lien position upon a record which makes no Finding whatever as to the value of the first lien security

but which contains two estimates or statements respecting the earnings or income derived from the leasehold estate of the Railroad Company in the lines of the Terre Haute Southeastern Railway Company in the year 1936 (the test year used by the Interstate Commerce Commission as the basis for all security allocations made by the Plan) one, which is referred to in the Report of the Interstate Commerce Commission, showing net income in 1936 applicable to bond interest of $875,327, the other, embodied in a specific Finding of the District Court, showing income for the identical year in the amount of $1,966,546—a variation of $1,091,219 which, if capitalized at 4½%, discloses an undervaluation of the first lien security for the Fifty Year Bonds on this item *alone* of $24,249,000 (Tr. 196, 2252).

The Petitioners in No. 875-883 say in their Brief:

> "If, as we believe, the Commission's findings in this case are sufficient, we urge this Court to approve the certified plan rather than to remand the case to the Circuit Court of Appeals."

In view of the state of the record of which the treatment of the Fifty Year Bonds outlined above is fairly typical, we think that for sheer audacity this proposal is without a parallel in the annals of this Court.

There is scarcely a provision of the "certified" Plan which is not irreconcilable with *Consolidated Rock Products* v. *Du Bois* and other controlling decisions of this Court. This we submit is made abundantly clear by what has already been said and by the further illustrations appearing in the Cross Petition for a *Writ of Certiorari* filed by the Railroad Company, and the Brief in support thereof, copies of which, for the convenience of the Court, are hereto annexed.

Accordingly, we urge that the Petition for *Writ of Certiorari* asked by the Petitioners in No. 875-883 and No. 988 be denied as unwarranted by the usages of this Court.

Respectfully submitted,

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